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# Pension Funds Still Waiting for Big Payoff From Private Equity

By JENNY ANDERSON

**Private equity** deal-makers, those kings of corporate buyouts, made billions for themselves when times were good. But some of their biggest investors, public pension funds, are still waiting for the hefty rewards they were promised.

The nation's 10 largest public pension funds have paid private equity firms more than \$17 billion in fees since 2000, according to a new analysis conducted for The New York Times, as the funds flocked to these so-called alternative investments in hopes of reaping market-beating returns.

But few big public funds ended up collecting the 20 to 30 percent returns that private equity managers often held out to attract pension money, a review of the funds' performance shows.

Many public pension funds are struggling to recover from a collapse in the value of their portfolios, despite large private equity investments that were supposed to help cushion their losses.

Fees are at the center of the debate over the divergent fortunes of private equity managers and their investors, because fees often make a big dent in any investment gains.

That "raises the question as to why they accept to pay this level of fees," said Oliver Gottschalg, a professor at the HEC School of Management in Paris who conducted the study on private equity fees.

State and local pension assets declined by 27.6 percent from the end of 2007 to the end of 2008, wiping out \$900 billion, according to the [Government Accountability Office](#).

Those poor returns have rankled some longtime private equity investors like the [California Public Employees' Retirement System](#), or Calpers. In September 2009, it "strongly endorsed" principles proposed by the Institutional Limited Partners Association, which represents private equity investors, to keep management fees in check and improve disclosure about fund performance.

The funds vary in how they report their performance and calculate their returns, allowing a significant number to classify themselves as "top quartile," or the best performers.

"The fees paid to private equity managers has been a source of great frustration," Joseph A. Dear, the chief investment officer for Calpers, said in an interview, adding that the managers "shouldn't be making a profit on the management fee. They should make money when their investors make money."

Still, despite the high fees, he said the funds' performance had been good. "We don't expect 20 percent," he said. "We expect 3 percent more than public markets, net of fees."

Private equity executives generally say their fees are justified by their market-beating returns. Reached by e-mail on Friday, Robert W. Stewart, a spokesman for the Private Equity Council, the industry's trade association, declined to comment.

Public funds pay a lot of money to managers of so-called alternative investments like private equity, [venture capital](#), real estate and hedge funds. In 2009, the Pennsylvania Public School Employees' Retirement System paid \$477.5 million in fees — 20 percent more than it did in 2008 and 283 percent more than in 2000, the earliest year for which data was available.

These funds generally charge fees totaling 2 percent of the money they manage and then take 20 percent of the profits they generate.

And yet, even after paying hundreds of millions of dollars in fees, the Pennsylvania fund is ailing. It lost more than a quarter of its value during its latest fiscal year and is now worth less than it was a decade ago, although its performance has improved recently.

Private equity owes its explosive growth largely to America's pension funds. Buyout funds raised \$200 million in 1980 and \$200 billion in 2007. According to Prequin, a financial data provider, public pension funds were the biggest contributors over that period and now have \$115.9 billion invested in private equity.

But these investments have not worked out as well as many had hoped. According to data from the Wilshire Trust Universe Comparison Service, the median returns for public pension funds with assets greater than \$5 billion were negative 18.8 percent over one year, negative 2.8 percent over three years, and 2.4 percent over five years.

Indeed, research conducted by several university professors challenge the private equity firms' premise that returns beat the stock market over long periods of time.

Two professors, Steven Kaplan of the [University of Chicago](#) and Per Strömberg of the Stockholm School of Economics, contend that, after fees, many private equity investments just about match or even trail the returns of the broad stock market between 1980 and 2001.

Additional research by Ludovic Phalippou of the University of Amsterdam and Mr. Gottschalg of the HEC School of Management shows that private equity funds underperformed the Standard & Poor's 500-stock index by 3 percent annually from 1980 to 2003, after accounting for fees.

To be sure, private equity returns have beaten abysmal stock market returns over the last decade, helping to provide a cushion at some funds. For Pennsylvania's public school workers, the 10-year return for private equity was 9.5 percent, even after deducting for fees, compared to 3.6 percent for all assets, including stocks and bonds.

The largest pension fund investors put a significant chunk of their money in private equity during the bubble years, from 2005 to 2008, according to a separate analysis by Mr. Gottschalg. Of the top 10 pension funds, eight invested more than 45 percent of their total capital in private equity during that period.

Mr. Kaplan said that the funds started during the boom years, so-called vintage funds, were likely to disappoint investors.

"The deals of 2006 and 2007 will not perform very well," Mr. Kaplan said, referring to mergers and

acquisitions led by private equity firms that have not yet been cashed out through a sale.

Some big funds are doubling down on private equity anyway. In November 2007, the Washington State Investment Board, whose \$75 billion fund is among the most heavily invested in private equity, increased its commitment to that asset class to 25 percent, from 15 percent, and its real estate allocation to 13 percent, from 12 percent.

Others, however, are retrenching. As of last September, the Pennsylvania State Employees' Retirement System, a \$24.3 billion fund that is distinct from the school workers' fund, had 23 percent of its pension investments in hedge funds, another 23 percent in private equity and venture capital, and an additional 8.4 percent in real estate — bringing its total in alternative investments to more than 54 percent.

A spokesman for the fund, Robert Gentzel, said it was working to scale back those allocations to 12 percent for private equity and venture capital and 9 percent for hedge funds.

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